REPORT

OF THE UNIFORM COMMERCIAL CODE COMMITTEE

OF THE BUSINESS LAW SECTION

OF THE STATE BAR OF CALIFORNIA

ON THE

AMENDMENTS TO UNIFORM COMMERCIAL CODE ARTICLES 3 AND 4

PROMULGATED BY

THE NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS

AND

THE AMERICAN LAW INSTITUTE

January, 2003

This report, prepared by the Uniform Commercial Code Committee of the State Bar of California Business Law Section (the "Committee"), addresses the 2002 Amendments to Uniform Commercial Code Articles 3 and 4 (the "Amendments"), promulgated by the National Conference of Commissioners on Uniform State Laws ("NCCUSL") and the American Law Institute ("ALI"). The report discusses in detail how the Amendments would affect current California law.

Mindful of the ever-growing importance of uniformity in our increasingly national economy, the necessity of modernizing laws to reflect technological developments, and the desirability of addressing issues that have come to light during the past decade**, the Committee strongly recommends the prompt adoption in California of the Amendments in their uniform text**.

As noted in the preface to the Amendments, the proposed revisions stem from a request made by the Federal Reserve Board to NCCUSL concerning provisions of Regulation CC (12 C.F.R. Part 229) that govern certain matters related to check collection. Support for the project initiated by ALI and NCCUSL based on this request proved inadequate. Accordingly, in the summer of 2001, the Executive Committee of NCCUSL modified the scope of the project to address solely those items that were plainly in need of reform and would raise little controversy. Apart from providing a number of technical corrections, the Amendments primarily focus on provisions of Article 3 ("Existing Uniform Article 3") and Article 4 ("Existing Uniform Article 4") of the Uniform Commercial Code pertaining to certain substantive topics.

This report addresses the major sections affected by the Amendments, specifically those dealing with transfers of lost instruments, electronic communications, declarations of loss, telephonically generated checks, payment and discharge of obligations, suretyship and consumer notes. It does so in each case, first, by summarizing any change that would be effectuated in California law. The report then discusses current California law and, more specifically, provisions of Division 3 ("Existing California Division 3") and Division 4 ("Existing California Division 4") of the California Uniform Commercial Code as currently in effect (the "Existing CUCC") and any other applicable California law that would be affected by the Amendments. Finally, in each case, this report makes specific recommendations regarding the adoption of the Amendments that are indicated in italic type. Existing Uniform Article 3, as amended by the Amendments, is referred to as Revised Article 3 ("RA3"), and Existing Uniform Article 4, as amended by the Amendments, is referred to as Revised Article 4 ("RA4"). Unless otherwise specified, references to Sections are to sections of RA3 and RA4, and references to Official Comments are references to the Official Comments promulgated with the Amendments.

A. TRANSFERS OF LOST INSTRUMENTS: COMMENTS TO SECTION 3-309 OF RA3.

1. Summary of Proposed Amendments.

The proposed revision to Section 3309 of Existing California Division 3 amends subsection (a) to provide that a person not in possession of an instrument may enforce that instrument if s/he either (1) was entitled to enforce the instrument when the loss of possession occurred or (2) directly or indirectly acquired possession of the instrument from a person who was entitled to enforce the instrument when loss of possession occurred. Subsection (b) of Section 3309 of Existing California Division 3, which sets forth the evidentiary burden of a person seeking enforcement of an instrument under subsection (a), remains essentially unchanged.

2. Current Law.

Section 3-804 of the original Uniform Article 3 provided a method for recovery by an owner on instruments that were lost, destroyed or stolen "upon due proof of his ownership, the facts which prevent his production of the instrument and its terms." In the 1990 revision, adopted by California in 1992, the remedy was more precisely stated in Section 3-309(a) of Existing Uniform Article 3 without any indication by the drafters of any intent to substantively change or limit the remedy. Nevertheless, in 1997, one court read the provision to mean that a person not in possession of an instrument may enforce it only if s/he was in possession of the instrument at the time of loss of possession. *Dennis Joslin Co. v. Robinson Broadcasting Corp.*, 977 F. Supp. 491 (D.D.C. 1997). In *Joslin*, the plaintiff was denied recovery upon the instrument because it had purchased the loan from the FDIC and the promissory note evidencing the obligation had been lost while in the FDIC's possession. Notwithstanding that *Joslin* has not been followed or approved by any court, and, indeed, has been rejected by a number of courts, e.g. *Beal Bank S.S.B. v. Caddo Parish-Villas South*, 218 B.R. 851 (N.D. Tex.), *aff'd on other grounds*, 174 F.3d 624 (5th Cir. 1998); *Bobby D. Associates v. Di Marcantonio*, 751 A.2d 673 (Pa. Super.2000), it has produced much mischief and uncertainty.

3. Proposed Law and Analysis.

According to the Official Comments to Section 3-309 of RA3, subsection (a) has been revised to reject the result reached in *Joslin*. This rejection is consistent with the recent amendments to Section 9109 of the CUCC: Official Comment 5 to Section 9109 provides, in pertinent part, that "the right under Section 3309 to enforce a lost, destroyed, or stolen negotiable promissory note may be sold to a purchaser who could enforce that right by causing the seller to provide the proof required under that section. This Division rejects decisions reaching a contrary result, *e.g. Dennis Joslin Co. v. Robinson Broadcasting Corp*., 977 F. Supp 491 (D.D.C. 1997)."

The proposed revisions avoid the windfall to the maker of the negotiable promissory note which occurred in the *Joslin* case where the note, having been lost by the original holder could not be enforced by the buyer of the note. The *Joslin* case has not been followed and has been widely criticized. Neverthless, *Joslin* has created uncertainty in bank merger and acquisition transactions and in federal bank insolvency purchase and assumption transactions where the negotiable promissory note has not been found and the note has already been transferred to the buyer as part of a bulk transaction.

Even though the proposed revisions clarify the broader circumstances under which claimants under lost instruments may enforce them, the section, as revised, still contains the affirmative requirement that a court may not enter judgment in favor of a person seeking to enforce a lost instrument unless it finds that the person required to pay the instrument is adequately protected against duplicative claims. Section 3309(b) of Existing California Division 3, which provides that "[a]dequate protection may be provided by any reasonable means," will remain unchanged.

4. Committee Recommendation.

The Committee recommends that Section 3309 of Existing California Division 3 be amended by the adoption of the amendments to Section 3-309 of Existing Uniform Article 3 as set forth in the Amendments.

B. ELECTRONIC COMMUNICATIONS: COMMENTS TO SECTION 4-301 OF RA4.

1. Summary of Proposed Amendments.

Section 4-301 of RA4 expands and updates the alternatives available to a payor bank that has provided provisional settlement of a demand item in the event the payor bank elects to revoke the settlement and recover the amount paid. Section 4-301 of RA4 *adds* an alternative for the payor bank: the return of an image of the item (rather than the item itself), provided that (a) the party to which the return is made has agreed to accept an image of the item being returned in lieu of the item itself and (b) the image is returned in accordance with the terms of the agreement that allows for the return of an image. In addition, the section *modernizes* the alternative of a written notice of dishonor (as currently provided in the second alternative available to the payor bank when the item is not otherwise available) to a "record" that provides the notice of dishonor.[1]

2. Current Law.

Under current California law, a payor bank that settles a demand item (other than a documentary draft) may revoke the settlement and recover the settlement if, before the midnight deadline, the payor bank returns the item or, if the item is unavailable for return, sends written notice of dishonor.

3. Proposed Amendments and Analysis.

As indicated in new Official Comment 8 to Section 4-301 of RA4, allowing for the return of an image of an item, rather than the item itself, is intended to facilitate electronic check-processing, as well as make it clear to third parties (such as the depositor of the item) that the return of an image of an item that meets the requirements described in Section 4-301 of RA4 (*i.e.*, it is allowed pursuant to an agreement and the return occurs before the midnight deadline) is an effective and timely return of the item.

The Board of Governors of the Federal Reserve System, in its comments to Congress that accompanied the proposed Check Truncation Act,[2] observed that banks have found it difficult to obtain agreements on a

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[1] *See* footnote 25, *infra*, and accompanying text discussing the definition of "record."

[2] The proposed Check Truncation Act, if and when it is passed and becomes law, would allow banks to collect and return a check using a "substitute check" instead of the original check. A "substitute check" is a paper reproduction of the original check that contains an image of the front and back of the original check, bears an MICR line containing all information required under generally applicable industry standards, conforms to industry standards with regard to paper stock and dimensions and is suitable for automated processing in the same manner as the original check. An issue may arise as to whether a substitute check meets the definition of the term "item" as used in Section 4-301 of RA4. An "item" is defined in Section 4104 of Existing California Division 4, as well as in Section 4-104 of RA4, as an instrument or a promise or order to pay money handled by a bank for collection or payment (with "instrument" being defined by Section 3104 of Existing California Division 3 and Section 3-104 of RA3, as an unconditional promise or order to pay a fixed amount of money, with or without interest or charges described in the promise or order). This definition of "item" does not appear to encompass the concept of a substitute check as such term is used in the Check Truncation Act. Accordingly, Section 4-301 of RA4 does not appear to cover return by use of substitute checks.

The proposed Check Truncation Act addresses this issue by providing that a substitute check is the legal equivalent of the original check for all purposes, including federal and state law (provided it meets certain criteria). Thus, a substitute check's return would operate as if the original item had been used, and the rules under Section 4-301 of RA4 would still apply. It would, however, be possible to challenge the return of a substitute check in a wholly intrastate transaction. It is conceivable that the payee may

large scale that allow for electronic presentation and return of items. Nevertheless, it would appear that requiring prior agreement is necessary to avoid mandating the receipt of returns in electronic form and thereby imposing an electronic method of return on institutions that may not be technologically equipped to handle such electronic processing requirements.

The change to the third alternative for return proposed by Section 4-301 of RA4 tracks similar changes made to other sections of Existing Uniform Article 3 and Existing Uniform Article 4. Under current law, this alternative would require the payor bank to send a written notice of dishonor. By revising the language and allowing for a record that provides a notice of dishonor, Section 4-301 of RA4 will permit the communication of the notice of dishonor by electronic means as well as in writing.

4. Committee Recommendation.

The Committee recommends that Section 4301 of Existing California Division 4 be amended by the adoption of the amendments to Section 4-301 of Existing Uniform Article 4 set forth in the Amendments. The Committee notes that, under current California law, a "record" is defined only in subsection (69) of Section 9102(a) of the Existing CUCC. This section applies only to Division 9 of the Existing CUCC. There is no definition of "record" in existing Division 1 of the CUCC, nor is the definition contained in Division 9 incorporated into the Amendments (under Section 4104 of RA4). If Revised Article 1 is adopted in California, the definition of "record" would appear at Section 1201(b)(31).[3] However, if the adoption of Revised Article 1 does not become effective in California prior to or concurrently with the effectiveness of the adoption of the Amendments in California, the Committee recommends that, in connection with the adoption of the Amendments, California include a non-uniform provision in Section 4104 of Existing California Division 4 to provide a definition of "record" that is the same as that contained in Section 1-201(b)(31) of Revised Article 1.

C. DECLARATION OF LOSS: COMMENTS TO SECTION 3-312 OF RA3.

1. Summary of Proposed Amendments; Analysis.

The only change proposed to be made to Section 3312 of Existing California Division 3 appears in subsection (a)(3) of Section 3-312 of RA3. That section defines "declaration of loss." Execution of a declaration of loss by a claimant under a lost, destroyed, or stolen cashiers, teller's or certified check is a prerequisite to an effective claim to the proceeds of that check.

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challenge the effectiveness of the return of a substitute check, arguing that it does not meet the requirements of Section 4-301 of RA4 and that the Check Truncation Act is inapplicable as a constitutional matter.

A solution to the substitute check issue may be found in the third alternative available to the payor bank under Section 4-301(a)(3) of RA4. The issue of improper return only arises if a substitute check were deemed not to be an item. But if the payor bank is not in possession of the item, then Section 4-301(a)(3) of RA4 allows the payor bank to send a "record" providing notice of dishonor or nonpayment. In other words, assuming a substitute check is presented for collection and a substitute check is not an item under Section 4-301 of RA4, then the item would not be available for return, allowing the payor bank to return a "record" providing notice of dishonor. The substitute check would be a "record" providing notice of dishonor under Section 4-301(a)(3) of RA4. Of course, this solution presumes that the presentment of a substitute check will be effective.

The Committee notes that it is premature to address this issue at this point. Depending on if and how the courts respond to a challenge brought by a payee or other party, this issue may need to addressed in the future at the state law level.

[3] Section 1-201(b)(31) of Revised Article 1 defines a record as "information that is inscribed on a tangible medium or which is stored in an electronic or other medium and is retrievable in perceivable form." This provision is identical to Section 9102(a)(69) of the Existing CUCC, except for an additional qualifier contained in Section 9102(a)(69) ("except as used in 'for the record,' 'of record,' record or legal title,' and 'record owner'").

Section 3-312(a)(3) of RA3 would change the requirement that a declaration of loss be "a written statement." Instead, it would provide that a declaration of loss may be made "in a record." According to the Reporter's Notes to such section, "[t]he revision rests on the view that the policy of that subsection should be satisfied to the extent other procedures permit a statement to be made under penalty of perjury that is in an electronic form rather than in writing."[4]

2. Committee Recommendation.

The Committee recommends that Section 3312 of Existing California Division 3 be amended by the adoption of the amendments to Section 3-312 of Existing Uniform Article 3 set forth in the Amendments. The Committee notes that, under current California law, a "record" is defined only in subsection (69) of Section 9102(a) of the Existing CUCC. This section applies only to Division 9 of the Existing CUCC. There is no definition of "record" in existing Division 1 of the CUCC, nor is the definition contained in Division 9 incorporated into the Amendments (under Section 3-103(b) of RA3). If Revised Article 1 is adopted in California, the definition of "record" would appear at Section 1201(b)(31).[5] However, if the adoption of Revised Article 1 does not become effective in California prior to or concurrently with the effectiveness of the adoption of the Amendments in California, the Committee recommends that, in connection with the adoption of the Amendments, California include a non-uniform provision in Section 3103 of Existing California Division 3 to provide a definition of "record" that is the same as that contained in Section 1-201(b)(31) of Revised Article 1.

D. TELEPHONICALLY GENERATED CHECKS: COMMENTS TO SECTIONS 3-416 AND 3-417 OF RA3 AND SECTIONS 4-207 AND 4-208 OF RA4 (AND RELATED SECTION 3-103).

1. Summary of Proposed Amendments.

In 1996, California adopted non-uniform amendments to the then existing California Uniform Commercial Code to address demand drafts – writings not signed by a bank customer that are created by third parties (typically, telemarketers and home banking service providers) under the purported authority of the customer to charge that customer's account with the payor bank. Those amendments were enacted to reallocate the loss sustained by payor banks for paying unauthorized demand drafts to the other parties in the chain of transfer, presentation and collection.

While current California law reallocates risk of loss on demand drafts for both consumer and commercial transactions, the Amendments would only reallocate the risk in the case of items drawn on consumer accounts. In addition, while California law automatically treats demand drafts as checks, with all of the attendant legal ramifications, the Amendments would treat "demand drafts" as "items" and leave to the other law the determination as to whether they are "checks." As such, the Amendments are narrower in scope and relate solely to "remotely-created consumer items" (which are discussed *infra*). Finally, in the interstate context, the proposed Amendments do not require reciprocity, as does current California law, to effect the risk re-allocation effected by existing California law; nevertheless, if the Amendments are adopted uniformly, a similar result would ensue.

2. Current Law.

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[4] It is unclear what the reporter means by the qualification "to the extent other procedures permit." The text of Section 3-312 of RA3 does not similarly qualify the provision permitting declarations of loss to be made "in a record."

[5] Section 1-201(b)(31) of Revised Article 1 defines a record as "information that is inscribed on a tangible medium or which is stored in an electronic or other medium and is retrievable in perceivable form." This provision is identical to Section 9102(a)(69) of the Existing CUCC, except for an additional qualifier contained in Section 9102(a)(69) ("except as used in 'for the record,' 'of record,' record or legal title,' and 'record owner'").

Under Section 3104 of Existing California Division 3, a demand draft is a writing, not signed by a bank customer, that is created by a third party under the purported authority of that customer for the purpose of charging the customer's account with a bank. To be considered a demand draft, the writing must contain the customer's bank account number. The writing may also contain additional information, such as the customer's name or a notation that the customer authorized the issuance of the draft (or a statement to the effect that no signature is required). A demand draft, however, does not include a check purportedly signed and drawn by a fiduciary.

Section 3416 of Existing California Division 3 provides that transferors of demand drafts are deemed to give certain warranties to their transferees and, if the transfer is effected by indorsement, to any subsequent transferees. Section 3417 of Existing California Division 3 provides that a person obtaining payment or acceptance of a demand draft is deemed to make at the time of presentment, and a previous transferor of the demand draft is deemed to make at the time of transfer, various warranties to the drawee making payment or accepting the draft in good faith. Principal among those transfer/presentment warranties is that the demand draft is a check, the creation of which was authorized by the person identified as the drawer on the terms stated on the face of the draft. As a result, the drawee or acceptor of the demand draft is authorized to recoup its loss for payment or acceptance of an unauthorized item back up the chain of transfer, and tranferees may recoup their losses from prior transferors. Similar provisions are found in Sections 4207 and 4208 of Existing California Division 4, which deal with warranties given by customers and intermediary banks that transfer a demand draft and receive settlement and warranties given by the bank presenting the item for payment.

When enacted in California, these provisions effected a departure from the traditional rule for checks not authorized by the purported drawer set forth in *Price v. Neal*, 971 Eng. Rep. 871 (K.B. 1762). Under *Price v. Neal*, the payor bank is responsible, and must bear the loss, for any item it honors bearing an unauthorized signature of the drawer. However, in the context of demand drafts, the existing California provisions allow the payor bank to shift the loss back to the depositary institution. This shifting of the loss is premised on the theory that depositary banks, by virtue of their relationships with their customers, are in a better position to address abuses with respect to demand drafts than are payor banks. The allocation of risk of loss to depositary banks does not have any substantial effect on customers except to the extent that it may affect how depositary banks treat those customers who make deposits of demand drafts.

Sections 3416 and 3417 of Existing California Division 3 and Sections 4207 and 4208 and Existing California Division 4 contain reciprocity provisions which provide that, in order for a party to receive the benefit of the warranties contained in such sections, that party must be legally obligated under the laws of its jurisdiction to provide the same warranties if the situation were reversed. These reciprocity provisions were enacted primarily to protect California depository and intermediary banks in the interstate context. The Committee has identified Texas, Idaho and New Hampshire as having adopted laws attempting to address this issue.

3. Proposed Law and Analysis.

Unlike Existing California Division 3, RA3 does not contain a definition of "demand drafts." Instead, RA3 adopts a new definition to address analogous instruments drawn on accounts established by an individual for personal, family or household purposes. These instruments are defined in Section 3-103(a)(16) of RA3 as "remotely-created consumer items": they are items drawn on a consumer account (and not created by the payor bank) which do not bear a handwritten signature purporting to be that of the consumer.[6] RA3 does not specifically provide that a remotely-created consumer item constitutes a "check"

[6] The fiduciary exclusion currently a part of Section 3104(k) of Existing California Division 3 has not been included as it is inconsistent with a consumer account.

for purposes of RA3 or RA4; however, it appears, from the definitions of "negotiable instrument," "instrument," "draft" and "check" in Existing Uniform Article 3, that such an item generally would constitute a "check."

Sections 3-417 and 3-418 of RA 3 and Sections 4-208 and 4-209 of RA4 contain new warranties given by transferees, depositary banks, intermediary banks and presenting banks with respect to remotely-created consumer items. In brief, the warranties provide assurance that the person on whose account an item is drawn authorized its issuance in the amount for which it is drawn. In the case of items drawn on consumer accounts, these warranties are comparable to those given under current California law. Unlike current California law, these warranties would not be made in the case of items drawn on non-consumer accounts. Since the Amendments contemplate the establishment of uniform laws, they contain no provisions to address the issue of reciprocity, which, as noted above, is a part of the existing California statute.

Apart from the ability of the payor bank to detect forged signatures, there have been a number of justifications for the allocation of loss rule in *Price v Neal*, including that the payor bank should know its customers' signatures and wishes and that there is a clear and measurable benefit to the banking and commercial system by providing finality for the payment of items. In the context of unsigned demand drafts, the rationale is less compelling. In fact, depositary banks may be better suited to recover forgery-related losses from the depositors (with whom they have a relationship) than payor banks (who have no such relationship). Existing California law exemplifies this shift in focus. The Amendments reflect the same policy but are more narrowly focused, limiting their reach to the area in which problems are known to have arisen (i.e., the consumer rather than the commercial arena).

Balancing the ability of payor banks to avoid loss against the ability of other parties to do so (particularly banks dealing with customers who abusively use remotely-created consumer items), both current California law and the Amendments would permit reallocation of losses from payor banks. The Amendments, however, change California law in that they do not effect a reallocation of risk in the case of items that are not consumer items. Such items, though, are rare, and the appropriate method for allocating risks is less clear in the case of commercial items than it is in the case of consumer items. Likewise, while the Amendments eliminate the automatic characterization of remotely-created consumer items as "checks," appropriate characterization as some other type of item would not be likely, and the treatment as checks of any items that are not checks may be problematic. On balance, the benefits to be derived from broad adoption of the Amendments in a uniform format weigh heavily in support of the adoption of the Amendments, particularly in view of the limited application of those areas of California law that will be changed by the Amendments. In the course of making this change to California law, provisions of California law addressing "demand drafts" should be eliminated.

4. Committee Recommendation.

The Committee recommends that (a) Sections 3103, 3416 and 3417 of Existing California Division 3 be amended by the adoption of the amendments to Sections 3-103, 3-416 and 3-417 of Existing Uniform Article 3 set forth in the Amendments and (b) Sections 4207 and 4208 of Existing California Division 4 be amended by the adoption of the amendments to Sections 4-207 and 4-208 of Existing Uniform Article 4 set forth in the Amendments. In addition, as highlighted above, the Committee notes that other provisions of California law specifically addressing "demand drafts" should be eliminated.[7]

E. PAYMENT AND DISCHARGE OF OBLIGATIONS: COMMENTS TO SECTION 3-602 OF RA3.

[7] *See* the following sections of Existing California Division 3 and Existing California Division 4: (a) Section 3103(b) (index of certain definitions); (b) Section 3104(f)(3) (definition of "check"); and (c) Section 3104(k) (definition of "demand draft").

1. Summary of Proposed Amendments.

Section 3602 of RA3 would permit an obligor on a note to discharge its obligations with respect to the note in one of two ways: (a) it could pay the person entitled to enforce the note (current law and as proposed to be amended); or (b) it could pay the person formerly entitled to enforce the note (as proposed to be amended) if the obligor has not been notified that (i) the note has been transferred and (ii) payment is to be made to a new party. While these provisions would change Section 3602 of Existing California Division 3, they would preserve the exceptions to discharge of an obligor's obligations that are contained in Section 3602(b) of Existing California Division 3.

2. Current Law.

Under Section 3602 of Existing California Division 3, an obligor on a note is not distinguished from an obligor on any other kind of negotiable instrument. In all cases, the obligor must pay the party entitled to enforce the instrument in order to discharge the obligor's obligations. If such payment is made, then the obligor's obligations are discharged unless one of the exceptions in Section 3602(b) applies.[8] Under existing Section 3602, payment to one formerly but not currently entitled to enforce the instrument does not constitute payment on the instrument.

Present law protects the transferee of an instrument as to the value of the instrument at the time of such transferee's acquisition thereof. It imposes no duty on either the transferor or the transferee to notify the obligor that the instrument has in fact been transferred. Accordingly, any payments made to the transferor after the time of transfer do not reduce the obligor's liability on the instrument as it existed at the time of transfer. While the transferor will have obligations to the obligor under other principles of law in respect to such payments, those obligations fall outside of Existing California Division 3 (as well as RA3). This distribution of risk is consistent with the historical view of negotiable instruments entering the stream of commerce and being enforceable by holders in due course in accordance with their terms, irrespective of the knowledge of their obligors. The traditional view has been that obligors are able to protect themselves by requiring the negotiable instruments to be exhibited to them prior to making payment. In practice, however, an obligor is not in the best position to ascertain who is the then current holder of the instrument; as such, the obligor may find itself, through no fault of its own, in a situation where it must make multiple payments to satisfy its obligations.

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[8] Under Section 3602(b) of Existing California Division 3, "[t]he obligation of a party to pay the instrument is not discharged under subdivision a) if either of the following applies:

> "(1) A claim to the instrument under Section 3306 is enforceable against the party receiving payment and (A) payment is made with knowledge by the payor that payment is prohibited by injunction or similar process of a court of competent jurisdiction or (B) in the case of an instrument other than a cashier's check, teller's check, or certified check, the party making payment accepted from the person having a claim to the instrument, indemnity against loss resulting from refusal to pay the person entitled to enforce the instrument.
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> "(2) The person making payment knows that the instrument is a stolen instrument and pays a person it knows is in wrongful possession of the instrument."

3. Proposed Law and Analysis.

Under Section 3-602 of RA3, an obligor on a note will be able to safely pay and discharge its obligations by tendering payment to the original holder of the note until it has received actual notice that the note has been transferred to a new holder and that payments are to be made to such holder. The comment to Section 3-602 of RA3 provides that the section has been amended to bring negotiable instrument law in line with Section 9-406(a) of the Uniform Commercial Code, Section 5.5 of the Restatement of Mortgages, and Section 338(1) of the Restatement of Contracts Section 338(1). The revised section is based upon the premise that, as between the obligor on a note and such note's former and current holders, the obligor is least likely to know of a change in the ownership of the note and, therefore, least able to know whether it is paying the party currently entitled to enforce it. Any new holder of the note, however, should not be disadvantaged by having to inform the obligor of the transfer; in fact, such notification may well alert the transferee to possible credit and other issues concerning the transferor and/or the note.

There are circumstances (such as the sale of a portfolio of notes), where, because the seller and the buyer believe that notification to an obligor might confuse that obligor and/or might lead to non-payment and/or increased administrative burdens in servicing the note (especially where a third party servicer is handling collection and enforcement of the note), no notice to the obligor will be given. In those circumstances, the buyer and the seller understand that payments may actually be made by the obligor to the seller. The buyer typically protects itself by providing in the purchase and sale agreement that any payments received by the seller with respect to the note are to be held in trust by the seller for the benefit of the buyer and are to be remitted by the seller to the buyer. Section 3-602 of RA3 is consistent with this practice, as it forces the parties to the transfer transaction to allocate between themselves the risks associated with non-notification, as they, and not the obligor, are in the better position to control where payments by the obligor are made.

4. Committee Recommendation.

The Committee recommends that Section 3602 of Existing California Division 3 be amended by the adoption of the amendments to Section 3-602 of Existing Uniform Article 3 set forth in the Amendments.

F. SURETYSHIP: COMMENTS TO SECTION 3-605 (AND RELATED SECTIONS 3-103, 3-116 AND 3-419) OF RA3.

1. Summary of Proposed Amendments.

Sections 3116, 3419 and 3605 of Existing California Division 3 address the rights of the parties to a negotiable instrument when there are multiple obligors on the instrument. Section 3116 provides that parties who are liable in the same capacity (such as co-makers) are jointly and severally liable and have rights of contribution against each other. Section 3419 provides that an accommodation party who pays the instrument is entitled to reimbursement from the accommodated party and may enforce the instrument against the accommodated party. Section 3605 indicates when actions by a person entitled to enforce a negotiable instrument (e.g., a promissory note or a check or other draft) discharge indorsers and accommodation parties. Sections 3-419 and 3-605 of RA3 would conform these rules to those contained in the Restatement of the Law, Third, on Suretyship and Guaranty. This change in California law would not affect guarantors and others who are not signatories on the note, check or draft, as their obligations and rights would continue to be governed by the suretyship laws contained in Sections 2787-2856 of the California Civil Code and applicable California case law.

2. Current Law.

Section 3605(b) of Existing California Division 3 provides that discharge of a party to a negotiable instrument (whether effectuated by signing a release of liability, surrendering or canceling the instrument, or

other intentional voluntary act under Section 3604 of Existing California Division 3) does not discharge an indorser or accommodation party that has a right of recourse against the discharged party. The discharged party remains liable to the indorser or accommodation party on the right of recourse. Thus, the discharged party's discharge is somewhat illusory. However, under Sections 3605(c), (d) and (e) of Existing California Division 3, if a person entitled to enforce the instrument agrees to a material modification of the obligation of a party, or an extension of the due date, which causes loss, in whole or in part, of the right of recourse, or if a person entitled to enforce such rights impairs the value of collateral, then indorsers and accommodation parties are discharged to the extent of the loss or impairment. In the case of a material modification of an obligation, Section 3605(c) of Existing California Division 3 creates a presumption, rebuttable by the person entitled to enforce against the indorser or accommodation party, that the loss is equal to the amount of the right of recourse (i.e., that the indorser or accommodation party is discharged in full).

3. Proposed Law and Analysis.

(a) Proposed Amendments.

(i) Broadened coverage. Section 3-605 of RA3 applies to "secondary obligors," a concept that is broad enough to encompass not only accommodation parties, but also joint and several obligors such as co-makers.[9]

(ii) Retention of Rights; Preservation of Recourse. Under Section 3-605(a) of RA3, if a person entitled to enforce an instrument releases the principal obligor in whole or in part, but wishes to retain such person's rights against a secondary obligor, the terms of the release must specifically provide that the person entitled to enforce the instrument retains the right to enforce the instrument against the secondary obligor. If the release contains such a provision but does not also provide that the principal obligor remains liable to the secondary obligor on the latter's right of recourse (and, thus, there is no "preservation of recourse"), the principal obligor is discharged both from liability on the instrument and from the secondary obligor's right of recourse except with respect to any payments made by the secondary obligor prior to the release. This loss of recourse of the secondary obligor might cause it a loss if it were to pay the instrument and would thereby be prevented from recovering from the principal obligor. Section 3-605 provides that the secondary obligor is discharged to the extent of any harm caused by the loss of recourse (as further discussed below). Indorsers of checks would be discharged to the same extent as the principal obligor regardless of the terms of the release.

(iii) The "Harm Principle." Under Section 3-605(a)(3) of RA3, the secondary obligor is discharged by a loss of its right of recourse only to the extent that the loss of recourse against the discharged principal obligor "would otherwise cause the secondary obligor a loss," i.e., to the extent of the actual harm to the secondary obligor. Even if recourse were preserved in a release, the secondary obligor would be discharged to the extent of the value given for the release and to the extent of any loss caused by the release, although in a preservation of recourse situation, loss is much less likely. Extension of the due date and any other modification of the obligation of the principal obligor, other than a complete or partial release, would also discharge the secondary obligor to the extent of the loss caused by the extension or modification; they would also give the secondary obligor the option of performing its obligations as if the extension or modification had not occurred or treating its obligations as having been extended or modified. As under Sections 3605(e) and (f) of Existing California Division 3, impairment of collateral discharges the secondary obligor to the extent of the impairment. *See* Section 3-605(c) of RA3.

(iv) Burden of Persuasion as to Loss. As a general rule, Section 3-605(h) of RA3 provides that a "secondary obligor asserting discharge has the burden of persuasion both with respect to the occurrence of the acts alleged to harm the secondary obligor and loss or prejudice caused by those acts." However, under

[9] Section 3-103 of RA3 includes new definitions of "principal obligor" and "secondary obligor." *See* Section 3-103 of RA3.

Section 3-605(i) of RA3, a secondary obligor who "demonstrates prejudice caused by an impairment of its recourse" would be entitled to a presumption that he is discharged in full, if the amount of loss is not reasonably susceptible of calculation or requires proof of facts that are not ascertainable, and the person entitled to enforce has the burden of persuasion as to any lesser amount.

(b) Analysis of the Proposed Amendments.

(i) Overview of Changes Effectuated by the Proposed Amendments.

In those limited circumstances in which parties are entitled to enforce negotiable instruments against secondary obligors who have not waived suretyship rights, adoption of Section 3-605 of RA3 could result in discharge of the secondary obligor and in loss of the secondary obligor's right of recourse against the principal obligor under circumstances in which the secondary obligor would not have been discharged, or would not have lost its right of recourse, under current law.

Circumstances in which the change in law would make a material difference include the following:

- The person entitled to enforce the instrument has released the principal obligor in whole or in part. *Result under Section 3605 of Existing California Division 3*: Secondary obligor is not discharged, even if it is harmed by the discharge; principal obligor remains liable to the secondary obligor. *Result under Section 3-605 of RA3*: Secondary obligor is discharged to the same extent as the principal obligor unless the release provides that the secondary obligor remains liable.

- The person entitled to enforce the instrument has released the principal obligor, in whole or in part, and the release provides that the secondary obligor remains liable, but the release does not constitute a "preservation of recourse." *Result under Section 3605 of Existing California Division 3*: Principal obligor is discharged by the person entitled to enforce the instrument but remains liable to the secondary obligor on the right of recourse. *Result under Section 3-605 of RA3*: Principal obligor is discharged both from its obligation to the person entitled to enforce the instrument and from its obligation to the secondary obligor on the right of recourse.

- The person entitled to enforce the instrument materially modifies the obligation of the principal obligor other than by an extension of the due date, and the secondary obligor asserts that it is discharged due to a loss caused by the modification. *Result under Section 3605(d) of Existing California Division 3*: Loss in the full amount of the right of recourse is presumed, and the person entitled to enforce has the burden of persuasion that the secondary obligor has not incurred such loss. *Result under Sections 3-605(h) and (i) of RA3*: No presumption; the secondary obligor has the burden of persuasion that it has incurred loss, unless the circumstances indicate that the amount of loss "is not reasonably susceptible of calculation or requires proof of acts that are not ascertainable."

In loan workouts and other settlement negotiations between a creditor and a principal obligor on an instrument, the proposed amendments would give the creditor a choice. If it wishes to settle for less than full payment from the principal obligor and still retain its rights against a secondary obligor, it would have to include language to this effect in the written release. The creditor then would have the option of disclosing to the principal obligor in the written release that the secondary obligor still has rights of recourse against the principal obligor, in which case the principal obligor would not be fully discharged but the creditor in most cases would fully retain its rights against the secondary obligor. Alternatively, the creditor may omit such disclosure, in which case the principal obligor would be fully discharged both from the creditor's claim on

the instrument and from the secondary obligor's right of recourse. In the latter case the creditor would assume the risk that the loss of recourse will cause actual loss to the secondary obligor and, consequently, that the secondary obligor would be discharged to the extent of that loss.

(ii) Evolution of Existing Uniform Article 3's Suretyship Provisions.

Uniform Article 3, as originally propounded decades ago, adopted the common law rule on discharge. Section 3-606(1) of original Uniform Article 3 provided that the holder would discharge "any party to the instrument to the extent that without such party's consent the holder…without express reservation of rights releases or agrees not to sue any person against whom the party has to the knowledge of the holder a right of recourse or agrees to suspend the right to enforce against such person the instrument or collateral or otherwise discharges such person."

Dissatisfaction with this suretyship rule spurred efforts at revision. In the 1990 revision, adopted by California in 1992, the pendulum swung all the way from the common law rule to a new rule that discharge of a party to an instrument by means of a signed release of liability or cancellation of the instrument does not discharge, at all, an indorser or accommodation party to that instrument who possesses a right of recourse against the discharged party. The stated purpose was to "allow a creditor to settle with the principal debtor without risk of losing rights against sureties." Official Comment 3 to Section 3605 of Existing California Division 3. The "reservation of rights" requirement, seen as a trap for the unwary creditor, was discarded. With respect to common types of provisions in loan workouts such as extensions of time and modification of terms, a "harm" standard was adopted, discharging an indorser or accommodation party only to the extent of any loss of that party's right of recourse.[10] In case of impairment to collateral, the liability of an indorser or accommodation party is effectively limited to what that party would have had to pay if the impairment had not occurred.[11]

The Restatement, Third, of Suretyship and Guaranty, completed in 1996, rejected the approach taken in Section 3-605(b) of Existing Uniform Article 3 and Section 3605(b) of Existing California Division 3, although it generally followed the principle of discharge only to the extent of harm embodied in subsections (c) and (d). The Restatement rejected what it called an "incantation" (Section 38, comment a) required in the release to preserve the rights of the creditor against the guarantor, and instead focused on whether the terms of the release of the principal obligor preserved the guarantor's rights of recourse. It introduced in Section 38 the concept of "preservation of recourse." Section 39(b)(ii) also reformulated the "reservation of rights" concept ("retain its claim against the principal obligor") and provided for the new consequence that when there is only a "reservation of rights" as distinguished from a "preservation of recourse", the principal obligor is also discharged from its recourse liability to the secondary obligor. Section 3-605(a)(2) of RA3 adopts that Restatement approach. *See* Official Comment 4 to Section 3-605 of RA3. Under the Restatement rule, the effect of a release without the guarantor's consent is to discharge the guarantor only if the guarantor's right of recourse is harmed, the so-called "harm" standard. Restatement of the Law, Third, Suretyship and Guaranty (1996), Section 39.

Section 3605(b) of Existing California Division 3 goes well beyond the Restatement rule. In Official Comment 3 to Section 3605 of Existing California Division 3, the drafters stated, "The release of Borrower by Bank does not affect the right of Accommodation Party to obtain reimbursement from Borrower or to enforce the note against Borrower if Accommodation Party pays Bank." This crucial qualification is not made clear in the text of Section 3605(b) of Existing California Division 3. For example, a savvy lender could enter into a workout with an unsophisticated borrower, collect part of the debt, and leave the

[10] Sections 3-605(c) and (d) of Existing California Division 3.

[11] Section 3-605(e) of Existing California Division 3.

accommodated borrower with the impression he/she was free from further obligation by simply remaining silent about the absent accommodation party, only for the borrower to discover later that the release was worthless due to the accommodation party's right of recourse against him/her. That is why the Restatement and Section 3-605(a) of RA3 reject Section 3605(b) of Existing California Division 3 (and Section3-605(b) of Existing Uniform Article 3).

(iii) Limited Impact of Existing Uniform Article 3's Suretyship Provisions.

The suretyship provisions of Section 3605 of Existing California Division 3 (and of Section 3-605 of Existing Uniform Article 3) have had limited impact for two reasons. First, they only apply to parties to negotiable instruments.[12] Although the text of Existing California Division 3 does not make it clear, Official Comment 3 to Section 3419 of Existing California Division 3 indicates that, where an instrument is guarantied in a separate document by one who has not signed the instrument, general suretyship law rather than Division 3 governs the rights and obligations of the guarantor. California has a suretyship statute, Sections 2787-2856 of the California Civil Code, which is inconsistent with Section 3-605 of Existing California Division 3.[13] Under Section 2819 of the California Civil Code, any alteration of the terms of the debt or the collateral for the debt - even a brief extension of time for payment or a modification favorable to the guarantor – exonerates a guarantor absent its consent. *Wise v. Clapper,* 257 Cal.App. 2d 770 (1968) and cases cited therein; *Brock v. Western National Indemnity Co.*, 132 Cal.App.2d 10 (1955).

The second reason why Section 3605 of Existing California Division 3 has had limited impact is the ubiquitousness and effectiveness of waivers of the suretyship defenses. At common law, the only way for a creditor to settle with and release the principal obligor while preserving its rights against a surety, without the surety's consent, was either to insert an express reservation of rights in its written release of the principal obligor (*Compagnie Financiere de CIC v. Merrill Lynch Pierce Fenner & Smith,* 188 F.3d 31, 36 (2nd Cir. 1999)) or to include waivers of the suretyship defenses in a written guaranty. In California, in the absence of a waiver of the guarantor's defenses and of the guarantor's consent, even an express reservation of rights in the release is of uncertain efficacy, as no California case has ever held a reservation of rights by a creditor to be effective in preserving its rights against a guarantor.[14]

Inevitably, lenders have adopted the practice of inserting waivers of the suretyship defenses in virtually all loan guaranties. *See* Official Comment 2 to Section 3605 of Existing California Division 3. Such waivers are generally enforceable. Civil Code §2856; *Riverbank America v. Diller,* 38 Cal.App.4th 1400 (1995); *Canadian Community Bank v. Ascher Findley Co.*, 229 Cal.App.3d 1139, 1154 (1991) In response to *Cathay Bank v. Lee*, 14 Cal.App.4th 1533 (1993), which held waivers of suretyship defenses unenforceable unless they met the exacting requirements for a waiver of statutory rights, in 1997 California adopted Section 2856

[12] The term "instrument" is defined in Section 3104(b) of Existing California Division 3 as "negotiable instrument." One becomes a party to a negotiable instrument by signing it, either manually or by means of a device or machine. See Section 3401 of Existing California Division 3. Parties to negotiable instruments may include makers of notes, drawers of drafts, indorsers, and acceptors. If a party signs for the benefit of another party to an instrument, and for the purpose of incurring liability on the instrument, that party is an "accommodation party" and the other is the "accommodated party." See Section 3419(a) of Existing California Division 3.

[13] The suretyship statute covers both suretyship and guaranty, the distinction between the two having been long ago abolished in California. Civil Code §2787. Eight other states also have suretyship statutes: Alabama, Georgia, Louisiana, Montana, North Dakota, Oklahoma, South Dakota, and Texas. See Ala. Code §§8-3-1 to 8-3-42 (1993); Ga. Code Ann. §§10-7-22 to 10-7-57 (1994); La. Civ. Code Ann. Art. 3047-3070 (West 1994); Mont. Code Ann. §§28-11-401 to 28-11-420 (1997); N.D. Cent. Code §§22-03-01 to 23-01-15 (1997); Okla. Stat. Ann. Tit. 15, §§371-385 (West 1993); S.D. Codified Laws §§56-2-1 to 56-2-17 (Michie 1997); Tex. Bus. & Comm. Code Ann. §§34.01-34.05 (West 1999).

[14] In the absence of a waiver by the guarantor, Civil Code §2845 gives the guarantor the right to require the creditor to proceed first against the principal. The only encouragement for a California creditor regarding the effectiveness of a reservation of rights is *dictum* in one California Court of Appeal decision, *Westinghouse Credit Corp. v. Wolfer*, 10 Cal.App.3d 63 (1970).

of the Civil Code, which validates the effectiveness of such waivers and sets forth "safe harbor" language that, if contained in a contract executed after 1996, assures an effective waiver. Because waivers of the suretyship defenses are commonplace and enforceable, financial institutions and sophisticated borrowers have had relatively little at stake in the ongoing debate about the "default" suretyship rules that apply in the absence of waivers.

(iv) Criticisms of Existing Uniform Article 3's Suretyship Provisions.

The 1990 revision of original Uniform Article 3's suretyship provisions has been criticized in several respects.[15] First is the lack of any requirement that the accommodated party be notified that he or she remains liable to the guarantor in case the guarantor pays the creditor. Critics have observed that the reservation of rights requirement at least has given the accommodated party, upon seeing the reservation of rights language in a proposed release, some reason to make further inquiry.

A second criticism of the 1990 revised version is the illusory nature of the protection afforded secondary obligors by their right to be discharged to the extent of loss with respect to their right of recourse.[16] This criticism is based on the difficulty of proving loss. Under the 1990 version of Section 3-605(b) of Existing Uniform Article 3 and comment (c) to that section, the existence of a right of recourse precludes discharge of the accommodation party, even if the effectiveness of that right of recourse is unknown or problematic. Where the accommodated party has settled without the knowledge or consent of the accommodation party, the latter may be an "outsider looking in" who is poorly situated to prove that a loss has occurred. Mitigating this problem was the shifting of the burden to the creditor in cases of material modification of the underlying obligation.

(v) Purposes of the Proposed Amendments.

The stated purpose of the proposed amendments is to conform the suretyship provisions in Section 3-605 of Existing Uniform Article 3 (and, thereby, Section 3605 of Existing California Division 3) to the Restatement rules. A secondary purpose of the amendments is to encourage courts to follow the Restatement of the Law, Third, on Suretyship and Guaranty in the broader range of transactions governed by general suretyship law and, perhaps, to promote the codification of the Restatement.[17]

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[15] *See* Sarah Howard Jenkins, "Revised Article 3: [Revise] It Again, Sam," 36 Houston L. Rev. 883 (1999); *see also* Neil B. Cohen, "Suretyship Principles in the New Article 3: Clarifications and Substantive Changes," 42 Ala. L. Rev. 595 (1991).

[16] Jenkins, *supra* note 15, at 899-905. In addition to the criticisms identified in the text, Professor Jenkins has also levied two additional criticisms. The first concerns the scope of Section 3-605 of Existing Uniform Article 3. Section 3-605 of Existing Uniform Article 3 (Section 3605 of Existing California Division 3) pertains to the discharge of indorsers and accommodation parties. No mention is made, however, of two other types of what the Restatement calls "secondary obligors." One is a drawer obligated under Section 3-414(d) of Existing Uniform Article 3 to pay a draft that has been accepted, other than by a bank, but is dishonored by the acceptor. The other type of secondary obligor not covered by Section 3-605 of Existing Uniform Article 3 (and Section 3605 of Existing California Division 3) is a party who pays an instrument and thereby acquires a right of contribution under Section 3-116(b) of Existing Uniform Article 3 (and Section 3116(b) of Existing California Division 3) against other parties who are jointly and severally liable with him on the instrument. This issue is addressed by Section 3-605 of RA3. *See* Official Comment 3 to Section 3-605 of RA3. The other criticism that Jenkins levies at Existing Uniform Article 3's suretyship provisions is that they can produce anomalies where a secondary obligor both signs the instrument and a loan agreement or guaranty. In such cases, in the absence of waivers, two divergent bodies of suretyship law could apply: Section 3-605(b) or Existing Uniform Article 3 to the obligation on the instrument, and the general suretyship statute to the underlying obligation on the loan agreement or guaranty. For example, a guarantor who also indorsed a promissory note as an accommodation indorser could find herself discharged on the guaranty yet, under Section 3-605(b) of Existing Uniform Article 3 (and Section 3605(b) of Existing California Division 3), still liable on the note. While theoretically possible, there is nothing to suggest that transactions are regularly or even infrequently documented in such a fashion.

[17] Private communication between Prof. Arnold S. Rosenberg, Thomas Jefferson School of Law, San Diego, and a member of the Committee, and Prof. Donald Rapson, Columbia University Law School, New York, October 1, 2002.

(vi) Comments on the Proposed Amendments.

(A) Reservation of Rights Redux.

The proposed amendments respond to the criticisms stated above by generally adopting the "harm" principle of subsections (c) and (d) of Section 3605 of Existing California Division 3 and of the Restatement, and by a concept of "preservation of recourse," which provides clearer information to principal obligors than does the antiquated concept of reservation of rights. To preserve its right to seek recovery of the unpaid deficiency from the secondary obligor upon a release of the principal obligor, the creditor has to include express language in the release reserving its rights against the secondary obligor (Section 3-605(a)(2) of RA3). Even if such language is in the release, the secondary obligor still would be discharged to the extent of any resultant harm under Section 3-605(a)(3) of RA3. The risk of such harm can be minimized if the reservation of rights language in the release also provides that the secondary obligor's recourse continues against the principal obligor as though the release had not been given, i.e. a "preservation of recourse" (Section 3-605(g) of RA3). *See* Section 3-605 of RA3, Comment 4, Cases 2, 3 and 4.

The preservation of recourse requirement represents a compromise between the interest of the principal obligor (often a delinquent borrower who signed a note) in full awareness of the consequences of a release, and the interest of the obligee (often the lender) in maximizing its ability to collect the debt through a workout with the principal obligor. Thus, the Drafting Committee commented, "Proposed §3-605…appropriately balances the interests of the creditor, the principal obligor and the secondary obligor. The principal obligor is not misled into bargaining for a release that purports to discharge the principal obligor when its liability to the secondary obligor remains."

(B) Allocation of the Burden of Persuasion as to Loss.

Adoption of the "harm" principle in Section 3-605 of RA3 heightens the importance of the allocation of the burden of persuasion as to loss. Sections 3-605(h) and (i) of RA3 place this burden on the secondary obligor, even where the creditor has agreed with the principal obligor to materially modify the obligation on the instrument. Section 3605(d) of Existing California Division 3 places the burden on the creditor in such cases. Because the secondary obligor has better access to information about its own losses, the proposed reallocation of the burden of persuasion is sensible.

(C) Elimination of Barriers to Effective Rights of Recourse.

The primary problem for the secondary obligor who has paid the creditor is how to enforce its rights of recourse against the principal obligor. At common law there were three rights of recourse: "exoneration" (the right to compel the principal obligor to perform); reimbursement; and subrogation to the rights of the creditor against the principal obligor. *See* Sections 2846-2848 of the California Civil Code. Section 3-419(e) of Existing Uniform Article 3 expressly preserves the last two but fails to mention the right of exoneration. Section 3-419(f) of RA3 expressly provides for the secondary obligor's right of exoneration, a salutary change.

(D) Unification of Divergent Bodies of Suretyship Law

Currently, there are in California two divergent bodies of law on suretyship – one, the UCC rule, applicable to parties to negotiable instruments and the other, the general suretyship statute and applicable case law, applicable in all other settings. The proposed amendments would largely conform UCC suretyship law to the Restatement approach and make more likely judicial resort to the Restatement in the non-UCC context. *Viz.*: "[I]t makes no sense to have two parallel bodies of law dealing with basically the same legal and economic circumstances, which use different terminology and sometimes produce conflicting legal

results, when the only difference is the document in which the secondary obligation appears…To the extent that the rules [in UCC Article 3 and the Restatement] are stated differently or produce different legal results, that is inefficient, costly and gives rise to uncertainty. Clearly, the language and rules should be the same. . . ."[18] By aligning the suretyship rules in Existing California Division 3 with those of the Restatement, it increases the likelihood that California courts will follow and apply the Restatement rules to California's general law of suretyship. In addition, the amendments would enable a move toward uniformity with the suretyship laws of other states (assuming their passage of the Amendments).

4. Committee Recommendation.

The Committee recommends that Section 3605 of Existing California Division 3 be amended by the adoption of the amendments to Section 3-605 of Existing Uniform Article 3 set forth in the Amendments.

G. CONSUMER NOTES: COMMENTS TO SECTION 3-305 OF RA3.

1. Summary of Proposed Amendments.

Section 3-305 of RA3 would amend current California law to clarify that there are no circumstances under which there can be a holder in due course of a negotiable instrument in a consumer transaction if laws other than the Existing CUCC require a statement to be included in the instrument to the effect that the rights of a holder or transferee are subject to a claim or defense that the issuer could assert against the original payee. According to new Official Comment 6, Section 3-305 of RA3 is being revised "to clarify the treatment of an instrument that omits the notice currently required by the Federal Trade Commission Rule related to consumer credit sales (16 C.F.R. Part 433)."

2. Current Law.

Under current California law, if an instrument in a consumer transaction is required to include a statement to the effect that the rights of a holder or transferee are subject to the claims or defenses of the consumer and such statement is, in fact, included in the instrument, there can be no holder in due course of such instrument. Existing California law also provides that, if such a statement is required with respect to a receivable other than a negotiable instrument arising from a consumer credit sale and such statement is omitted from the record evidencing the obligation, then the transferee of such receivable is subject to the consumer's claims and defenses pursuant to Section 9403(d)[19] and Sections 9404(c) and (d)[20] of the existing CUCC.

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[18] Letter from Prof. Donald Rapson, UCC Bulletin (Oct. 2002), p. 2, ¶2.

[19] Sections 9403(c), (d) and (e) of the Existing CUCC currently provide as follows:

> (c) Subdivision (b) does not apply to defenses of a type that may be asserted against a holder in due course of a negotiable instrument under subdivision (b) of Section 3305.
>
> (d) In a consumer transaction, if a record evidences the account debtor's obligation, law other than this division requires that the record include a statement to the effect that the rights of an assignee are subject to claims or defenses that the account debtor could assert against the original obligee, and the record does not include such a statement, then both of the following apply: (1) The Record has the same effect as if the record included such a statement. (2) The account debtor may assert against an assignee those claims and defenses that would have been available if the record included such a statement. . . .
>
> (e) This section is subject to law other than this division which establishes a different rule for an account debtor who is an individual and who incurred the obligation primarily for personal, family, or household purposes.

Official Comment No. 5 to Section 9403 of the Existing CUCC states that:

(a) Holder in Due Course.

A "holder in due course" is currently defined in Section 3302(a) of Existing California Division 3 as the holder of an instrument if both of the following apply:

> (1) The instrument when issued or negotiated to the holder does not bear such apparent evidence of forgery or alteration or is not otherwise so irregular or incomplete as to call into question its authenticity.
>
> (2) The holder took the instrument (A) for value, (B) in good faith, (C) without notice that the instrument is overdue or has been dishonored or that there is an uncured default with respect to payment of another instrument issued as part of the same series, (D) without notice that the instrument contains an unauthorized signature or has been altered, (E) without notice of any claim to the instrument described in Section 3306 of Existing California Division 3, and (F) without notice that any party has a defense or claim in recoupment described in subdivision (a) of Section 3305 of Existing California Division 3.

However, notwithstanding the general rules regarding holders in due course, Section 3302(g) of Existing California Division 3 provides that such Section 3302 "is subject to any law limiting status as a holder in due course in particular classes of transactions." Official Comment No. 7 to Section 3302 of Existing California Division 3 provides as follows with respect to the limitations contained in subsection (g):

> There is a large body of state statutory and case law restricting the use of the holder in due course doctrine in consumer transactions as well as some business transactions that raise similar issues. Subsection (g) subordinates Article 3 to that law and any other similar law that may evolve in the future. Section 3-106(d) also relates to statutory or administrative law intended to restrict use of the holder-in-due-course doctrine. See Comment 3 to Section 3-106.

> Subsection (d) is new. It applies to rights evidenced by a record that is required to contain, but does not contain, the notice set forth in Federal Trade Commission Rule 433, 16 C.F.R. Part 433. Under this subsection, an assignee of such a record takes subject to the consumer account debtor's claims and defenses to the same extent as it would have if the writing had contained the required notice. Thus, subsection (d) effectively renders waiver-of-defense clauses ineffective in the transactions with consumers to which it applies.

[20] Sections 9404(c) and (d) of the Existing CUCC currently provide as follows:

> (c) This section is subject to law other than this division which establishes a different rule for an account debtor who is an individual and who incurred the obligation primarily for personal, family, or household purposes.
>
> (d) In a consumer transaction, if a record evidences the account debtor's obligation, law other than this division requires that the record include a statement to the effect that the account debtor's recovery against an assignee with respect to claims and defenses against the assignor may not exceed amounts paid by the account debtor under the record, and the record does not include such a statement, the extent to which a claim of an account debtor against the assignor may be asserted against an assignee is determined as if the record included such a statement.

Official Comment No. 4 to Section 9404 of the Existing CUCC states that:

> Subsection (d) applies to rights evidenced by a record that is required to contain, but does not contain, the notice set forth in Federal Trade Commission Rule 433, 16 C.F.R. Part 433. Under subsection (d), a consumer account debtor has the same right to an affirmative recovery from an assignee of such a record as the consumer would have had against the assignee had the record contained the required notice.

Further, Section 3106(d) of Existing California Division 3 provides, among other things, that, if a promise or order contains a statement required by applicable law, there cannot be a holder in due course of the instrument. According to Official Comment No. 3 to Section 3106(d) of Existing California Division 3:

> The subsection [(d)] applies only if the statement is required by statutory or administrative law. The prime example is the Federal Trade Commission Rule (16 C.F.R. Part 433) preserving consumer's claims and defenses in consumer credit sales. The intent of the [FTC Holder Rule] is to make it impossible for there to be a holder in due course of a note bearing the FTC legend and undoubtedly that is the result. . . . The effect of the FTC legend is to make the rights of a holder or transferee subject to claims or defenses that the issuer could assert against the original payee of the note.

(b) The FTC Holder Rule.

Pursuant to 16 C.F.R. 433.2 (the "FTC Holder Rule"), it is an unfair or deceptive act or practice within the meaning of Section 5 of the Federal Trade Commission Act in connection with any sale or lease of goods or services to consumers[21] for a seller[22], directly or indirectly, to (a) take or receive a consumer credit contract[23] which fails to contain the FTC Legend (defined below), or (b) accept, as full or partial payment for such sale or lease, the proceeds of any purchase money loan[24] unless any consumer credit contract made in connection with such purchase money loan contains the FTC Legend. The following is the content of the notice (the "FTC Legend") that the FTC Holder Rule requires sellers to include in consumer credit contracts taken or received in a covered consumer transaction (the rule requires similar language to be included in consumer credit contracts made in connection with purchase money loans if the proceeds are accepted by sellers in full or partial payment under a covered consumer transaction):

> NOTICE: ANY HOLDER OF THIS CONSUMER CREDIT CONTRACT IS SUBJECT TO ALL CLAIMS AND DEFENSES WHICH THE DEBTOR COULD ASSERT AGAINST THE SELLER OF GOODS OR SERVICES OBTAINED PURSUANT HERETO OR WITH THE PROCEEDS HEREOF. RECOVERY HEREUNDER BY THE DEBTOR SHALL NOT EXCEED AMOUNTS PAID BY THE DEBTOR HEREUNDER.[25]

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[21] A "consumer" is defined in 16 C.F.R. 433.1(b) as a "natural person who seeks or acquires goods or services for personal, family or household use."

[22] A "seller" is defined in 16 C.F.R. 433.1(b)(j) as "a person who, in the ordinary course of business, sells or leases goods or services to consumers."

[23] A "consumer credit contract" is defined in 16 C.F.R. 433.1(b)(i) as "any instrument which evidences or embodies a debt arising from a 'Purchase Money Loan' transaction or a 'financed sale' as defined in paragraphs (d) and (e) of this section." A "Purchase Money Loan" is defined in 16 C.F.R. 433.1(d) as a cash advance which is received by a consumer in return for a "Finance Charge" (within the meaning of the Truth in Lending Act and Regulation Z), which is applied, in whole or substantial part, to a purchase of goods or services from a seller who (1) refers consumers to the creditor or (2) is affiliated with the creditor by common control, contract or business arrangement. "Financing a sale" is defined in 16 C.F.R. 433.1(e) as "extending credit to a consumer in connection with a "credit sale" (within the meaning of the Truth in Lending Act and Regulation Z). Regulation Z defines a "credit sale" as a sale in which (1) the seller is the creditor, and the consumer agrees to pay an amount substantially equivalent to or in excess of the total value of the property involved, and (2) either will become, or has the option of becoming the owner of the property upon compliance with the agreement for no additional consideration or for nominal consideration. (12 C.F.R. 226.2, subdivision (a)(16) (2002).)

[24] See, supra, note 6 for a definition of "purchase money loan."

[25] 16 C.F.R. 433.2(a).

In adopting the FTC Holder Rule, the FTC explained that The FTC Holder Rule is directed at the preservation of consumer claims and defenses. It requires that all consumer credit contracts generated by consumer sales include a provision which allows the consumer to assert his sale-related claims and defenses against any holder of the credit obligation. From the consumer's standpoint, this means that a consumer can (1) defend a creditor suit for payment of an obligation by raising a valid claim against the seller as a setoff, and (2) maintain an affirmative action for a return of monies paid on account against the creditor who has received payments. The latter remedy will be available only where a seller's breach is so substantial that a court is persuaded that rescission and restitution are justified. *See* 40 Fed. Reg. 53524 (Nov. 18, 1975).

By its terms, the FTC Holder Rule applies to sellers. It does not expressly apply to a person who purchases a negotiable instrument on which the seller had failed to include the required FTC Legend. It also does not expressly apply to a purchase money lender who does not include the required FTC Legend on consumer credit sales documentation, even if the lender is affiliated with the seller or was referred the transaction by the seller.

(c) Current California Law Where the Required FTC Legend Is Contained in the Negotiable Instruments.

Based upon Sections 3302(g) and 3106(d) of Existing California Division 3 (and the analogous provisions in Existing Uniform Article 3), it appears clear that, if the FTC Legend or a similar statement required by other law is included in an instrument, there cannot be a holder in due course of such instrument. Any proposed transferee of such instrument would be able to read the FTC Legend or such other statement and would know that, by accepting assignment of such instrument, the transferee would be subject to any claims and defenses available to the consumer.

(d) California Case Law Where the Required FTC Legend Is Not Contained in the Negotiable Instrument.

No case law was found in California where the FTC Legend was required but omitted from a consumer credit contract. However, the California Court of Appeal in *Music Acceptance Corporation v. Dan Lofing*, 32 Cal. App. 4th 610, 39 Cal Rptr. 2d 159, 1995 Cal. App. LEXIS 185 (1995), has rendered a decision in a case where an FTC Legend was included in a consumer credit contract though it arguably did not have to be included. The court held that, whether or not the FTC Legend was required to be included in a contract for the sale of a piano, the consumer was able to assert its defenses against the holder of the contract because the FTC Legend was in fact included in such contract. The court cited language from another court's reasoning that:

> In abrogating the holder in due course rule in consumer credit transactions, the FTC preserved the consumer's claims and defenses against the creditor-assignee. The FTC rule was therefore designed to reallocate the cost of seller misconduct to the creditor. The commission felt the creditor was in a better position to absorb the loss or recover the cost from the guilty party - - the seller.[26]

3. Proposed Law and Analysis.

The proposed amendments to Section 3305 of Existing California Division 3 (which is the same as Section 3-305 of Existing Uniform Article 3) set forth the treatment of a negotiable instrument relating to a consumer credit sale that omits the FTC Legend or another statement required by law to be included therein. Essentially, the amendments provide that there can be no holder in due course of any such instrument if the

[26] *Home Sav. Ass'n v. Guerra* (Tex. 1987) 733 S.W.2d 134, 135.)

FTC Legend or other required statement is omitted. By denying holder in due course status to a holder of a negotiable instrument in which a required FTC Legend is lacking, the amendments police direct compliance with the FTC Rule by sellers and encourage indirect compliance by certain classes of lenders. From a policy standpoint, the amendments take the position that the sellers and the affected lenders are in a better position to insure compliance with the FTC Rule than are typical consumers.

Consider first a transferee of a negotiable instrument in which a required FTC Legend is lacking. On the surface, it may appear unfair to deny holder in due course status in this circumstance to such a transferee where the transferee does not have the opportunity to read the FTC Legend or other required statement. Traditionally, one of the primary benefits of taking an assignment of a negotiable instrument is the ability of the transferee to become a holder in due course and thereby avoid various unknown claims and defenses. On the other hand, if the transferee knows or should know that the instrument was executed in a consumer credit transaction, it would not have the expectation of being a holder in due course.

The transferee, however, may easily protect itself before purchasing the negotiable instrument by investigating the seller's compliance with the FTC Rule and by bargaining for appropriate recourse to the seller or to its transferor if the seller actually failed to place the required FTC Legend on the negotiable instrument. Indeed, the proposed amendments would strike the balance between the rights of consumers and transferees in a fashion consistent with the position articulated by the California Court of Appeal in the *Music Acceptance Corporation* case: it would transfer the risks of consumer claims and defenses against a seller to the transferee, who is likely in a better position than the consumer to bear such risks.

Additionally, it may appear unfair to make a lender of a purchase money loan evidenced by a negotiable instrument that does not contain the FTC Legend on the negotiable instrument subject to unknown claims and defenses. In those cases, whether the FTC Legend is required to be included in the purchase money loan documents (i.e., the promissory note) may not be clear, particularly to the lender, because the applicability of the FTC Holder Rule will always be fact sensitive and relate to the business and conduct of the seller. Even though a seller may be required to use a lender's form of documentation regardless of the factual setting in which a transaction occurs, the FTC Holder Rule imposes on the seller, not the lender, the burden of requiring that the FTC Legend be included in the purchase money loan documentation in order for the seller to receive the proceeds of the loan. The burden exists, however, only in the circumstance where the lender is affiliated with or referred by the seller.

The proposed amendments to Section 3305 of Existing California Division 3 remove any incentive for the lender to omit or allow the seller to omit the FTC Legend in this situation. Placing the burden on the lender to insure compliance with the FTC Rule does not appear to inconvenience the lender inordinately, given that, for the FTC Holder Rule to apply to the lender at all, the lender must be affiliated with or referred by the seller – a fact that the lender ordinarily knows or should know. Once again, the lender or a transferee from the lender may protect itself before closing the transaction by investigating the seller's compliance with the FTC Rule and by bargaining for appropriate recourse to the seller or the transferee's transferor in the event that the FTC Holder Rule applies to the transaction.

To be sure, under current California law,[27] proposed transferees of accounts and non-negotiable chattel paper must understand that they will be subject to a consumer's claims and defenses for accounts and non-negotiable chattel paper arising out of consumer credit sales. While Section 3-305 of RA3 extends this concept to negotiable instruments, it does so merely by incentivizing affected lenders and transferees of negotiable instruments to apply similar due diligence techniques and obtain like protections from sellers and transferors. Indeed, by understanding these risks when taking assignments of consumer credit sales transactions or financing those transactions, the proposed transferee or lender can make intelligent credit decisions and set the proper price for the assignment or making of the loan.

[27] See Sections 9403(c), (d) and (e) and Sections 9404(c) and (d) of the Existing CUCC.

4. Committee Recommendation.

The Committee recommends that Section 3305 of Existing California Division 3 be amended by the adoption of the amendments to Section 3-305 of Existing Uniform Article 3 as set forth in the Amendments.

Respectfully submitted,

The Uniform Commercial Code Committee
of the Business Law Section of the State Bar of California

and

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